

1 **The Federal Reserve System**

- What is the history of American banking?
- How did the Federal Reserve Act of 1913 lead to further reform?
- How is today's Federal Reserve System structured?

2 **Banking History**

A Central Bank?

- The issue of a central bank has been debated since 1790, when the first Bank of the United States was created.
- Debate has centered around the amount of control a central bank should have over the nation's banking system.
- Following the Panic of 1907, a series of serious bank runs, Congress decided that a central bank was needed.

3 **The Federal Reserve Act of 1913**

1 The Federal Reserve Act of 1913

- The Federal Reserve System, often referred to as "the Fed," is a group of 12 regional, independent banks.
- Initially the Federal Reserve System did not work well because the actions of one regional bank would counteract the actions of another.

2 A Stronger Fed

- In 1935, Congress adjusted the Federal Reserve structure so that the system could respond more effectively to crises.
- Today's Fed has more centralized powers so that regional banks can work together while still representing their own concerns.

4 **Structure of the Federal Reserve**

- The Board of Governors
 - The Federal Reserve System is overseen by the seven-member Board of Governors of the Federal Reserve. Actions taken by the Federal Reserve are called monetary policy.
- Federal Reserve Districts
 - The Federal Reserve System consists of 12 Federal Reserve Districts, with one Federal Reserve Bank per district. The Federal Reserve Banks monitor and report on economic activity in their districts.
- Member Banks
 - All nationally chartered banks are required to join the Fed. Member banks contribute funds to join the system, and receive stock in and dividends from the system in return. This ownership of the system by banks, not government, gives the Fed a high degree of political independence.
- The Federal Open Market Committee (FOMC)
 - The FOMC, which consists of The Board of Governors and 5 of the 12 district bank presidents, makes key decisions about interest rates and the growth of the United States money supply.


5 **The Pyramid Structure of the Federal Reserve**

- About 40 percent of all United States banks belong to the Federal Reserve. These members hold about 75 percent of all bank deposits in the United States.

6 **Section 1 Assessment**

1. The Federal Reserve System was created to
 - (a) undermine the American banking system.
 - (b) extend the powers of government.
 - (c) stabilize the American banking system.

- (d) destabilize the American banking system.
- 2. Monetary policy is
 - (a) the research arm of the Federal Reserve.
 - (b) the twelve banking districts created by the Federal Reserve Act.
 - (c) the actions the Federal Reserve takes to influence the level of real GDP and the rate of inflation in the economy.
 - (d) the actions taken by the Bank of the United States.

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8  **Federal Reserve Functions**

- How does the Federal Reserve serve the federal government?
- How does the Federal Reserve serve banks?
- How does the Federal Reserve regulate the banking system?
- What role does the Federal Reserve play in regulating the nation's money supply?

9  **Serving Government**

- Federal Government's Banker
 - The Fed maintains a checking account for the Treasury Department and processes payments such as social security checks and IRS refunds.
- Government Securities Auctions
 - The Fed serves as a financial agent for the Treasury Department and other government agencies. The Fed sells, transfers, and redeems government securities. Also, the Fed handles funds raised from selling T-bills, T-notes, and Treasury bonds.
- Issuing Currency
 - The district Federal Reserve Banks are responsible for issuing paper currency, while the Department of the Treasury issues coins.

10  **Serving Banks**

- Check Clearing
 - Check clearing is the process by which banks record whose account gives up money, and whose account receives money when a customer writes a check.
- Supervising Lending Practices
 - To ensure stability in the banking system, the Fed monitors bank reserves throughout the system. The Fed also protects consumers by enforcing truth-in-lending laws.
- Lender of Last Resort
 - In case of economic emergency, commercial banks can borrow funds from the Federal Reserve. The interest rate at which banks can borrow money from the Fed is called the discount rate.

11  **The Journey of a Check**

- After you write a check, the recipient presents it at his or her bank.

12  **Regulating the Banking System**

① Reserves

- Each financial institution that holds deposits for its customers must report daily to the Fed about its reserves and activities.
- The Fed uses these reserves to control how much money is in circulation at any one time.
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② Bank Examinations

- The Federal Reserve examines banks periodically to ensure that each institution is obeying laws and regulations.
- Examiners may also force banks to sell risky investments if their net worth, or total assets minus total liabilities, falls too low.


13  **Regulating the Money Supply**

① Factors That Affect Demand for Money

1. Cash needed on hand (Cash makes transactions easier.)
2. Interest rates (Higher interest rates lead to a decrease in demand for cash.)
3. Price levels in the economy (As prices rise, so does the demand for cash.)
4. General level of income (As income rises, so does the demand for cash.)

② Stabilizing the Economy

- The Fed monitors the supply of and the demand for money in an effort to keep inflation rates stable.

14  **Section 2 Assessment**


1. The Federal Reserve provides all of the following services to the government except
 - (a) issuing currency
 - (b) acting as the federal government's banker
 - (c) handling government securities auctions
 - (d) combining all banks into a single, central bank
2. The Fed provides banks with all of the following services except
 - (a) issuing interest free loans
 - (b) check clearing
 - (c) acting as a lender of last resort
 - (d) supervising lending practices

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16  **Monetary Policy Tools**

- What is the process of money creation?
- What three tools does the Federal Reserve use to change the money supply?
- Why are some tools of monetary policy favored over others?

17  **Money Creation**

How Banks Create Money

- Assume that you have deposited \$1,000 dollars in your checking account. The bank doesn't keep all of your money, but rather lends out some of it to businesses and other people.
- The portion of your original \$1,000 that the bank needs to keep on hand, or not loan out, is called the required reserve ratio (RRR). The RRR is set by the Fed.
- As the bank lends a portion of your money to businesses and consumers, they too may deposit some of it. Banks then continue to lend out portions of that money, although you still have \$1,000 in your checking account. Hence, more money enters circulation.

18 **The Money Creation Process**

19 **Reserve Requirements**

1 Reducing Reserve Requirements

- A reduction of the RRR would free up reserves for banks, allowing them to make more loans.
- A RRR reduction would also increase the money multiplier. Both of these effects would lead to a substantial increase in the money supply.

2 Increasing Reserve Requirements

- Even a slight increase in the RRR would require banks to hold more money in reserve, shrinking the money supply.
- This method is not used often because it would cause too much disruption in the banking system.

20 **Discount Rate**

1 Reducing the Discount Rate

- If the Fed wants to encourage banks to loan out more of their money, it may reduce the discount rate, making it easier or cheaper for banks to borrow money if their reserves fall too low.
- Reducing the discount rate causes banks to lend out more money, which leads to an increase in the money supply.

2 Increasing the Discount Rate

- If the Fed wants to discourage banks from loaning out more of their money, it may make it more expensive to borrow money if their reserves fall too low.
- Increasing the discount rate causes banks to lend out less money, which leads to a decrease in the money supply.
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21 **Open Market Operations**

1 Bond Purchases

- In order to increase the money supply, the Federal Reserve Bank of New York buys government securities on the open market.
- The bonds are purchased with money drawn from Fed funds. When this money is deposited in the bank of the bond seller, the money supply increases.

2 Bond Sales

- When the Fed sells bonds, it takes money out of the money supply.
- When bond dealers buy bonds they write a check and give it to the Fed. The Fed processes the check, and the money is taken out of circulation.

22 **Section 3 Assessment**

1. The required reserve ratio is the ratio of
 - (a) deposits to reserves required of banks by the Federal Reserve.
 - (b) accounts to customers required of banks by the Federal Reserve.
 - (c) reserves to deposits required of banks by the Federal Reserve.
 - (d) paper currency to coins required of banks by the Federal Reserve.

2. All of the following will increase the money supply except
 - (a) increasing the required reserve ratio
 - (b) bond purchases by the Fed
 - (c) reducing the required reserve ratio
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24  **Monetary Policy and Macroeconomic Stabilization**

- How does monetary policy work?
- What problems exist involving monetary policy timing and lags?
- How can predictions about the length of a business cycle affect monetary policy?
- What are the expansionary and contractionary tools of fiscal and monetary policy?

25  **How Monetary Policy Works**

1 The Money Supply and Interest Rates

- The market for money is like any other, and therefore the price for money — the interest rate — is high when the money supply is low and is low when the money supply is large.

2 Interest Rates and Spending

- If the Fed adopts an easy money policy, it will increase the money supply. This will lower interest rates and increase spending. This causes the economy to expand.
- If the Fed adopts a tight money policy, it will decrease the money supply. This will push interest rates up and will decrease spending.

26  **The Problem of Timing**

1 Good Timing

- Properly timed economic policy will minimize inflation at the peak of the business cycle and the effects of recessions in the troughs.

2 Bad Timing

- If stabilization policy is not timed properly, it can actually make the business cycle worse.


27  **Policy Lags**

1 Inside Lags

- An inside lag is a delay in implementing monetary policy.
- Inside lags are caused by the time it actually takes to identify a shift in the business cycle.

2 Outside Lags

- Outside lags are the time it takes for monetary policy to take effect once enacted.

28  **Anticipating the Business Cycle**

1 Monetary Policy and Inflation

- Expansionary policies enacted at the wrong time can push inflation even higher.

- If the current phase of the business cycle is anticipated to be short, policymakers may choose to let the cycle fix itself. If a recession is expected to last for years, most economists will favor a more active monetary policy.

2 How Quickly Does the Economy Self-Correct?

- Economists disagree about how quickly an economy can self-correct. Estimates range from two to six years.
- Since the economy may take quite a long time to recover on its own, there is time for policymakers to guide the economy back to stable levels of output and prices.

29  **Fiscal and Monetary Policy Tools**

The federal government and the Federal Reserve both have tools to influence the nation's economy.

30  **Section 4 Assessment**

1. Monetarism is
 - (a) the time it takes to enact monetary policy.
 - (b) the belief that the money supply means little to macroeconomic performance.
 - (c) the time it takes for monetary policy to take affect.
 - (d) the belief that the money supply is the most important factor in macroeconomic performance.
2. Tight money policies aim to
 - (a) increase the money supply and expand the economy.
 - (b) decrease the money supply and expand the economy.
 - (c) decrease the money supply and slow the economy.
 - (d) increase the money supply and slow the economy.

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